

# The mystery of capital: Why capitalism triumphs in the West and fails everywhere else

– A CDE seminar

Hernando de Soto

Imagine a country where nobody can identify who owns what, addresses cannot be easily checked, people cannot be made to pay their debts, resources cannot conveniently be turned into money, ownership cannot be divided into shares, descriptions of assets are not standardised and cannot be easily compared, and the rules that govern property vary from neighbourhood to neighbourhood or even from street to street.<sup>1</sup>

You have just put yourself into the life of a developing country or former Communist nation. More precisely, you have imagined life for 80% of the population, which is marked off as sharply from the country's Westernized elite as black and white South Africans were once separated by apartheid.<sup>2</sup> This 80% majority is not, as Westerners often imagine, desperately impoverished. In spite of their obvious poverty, even those who live under the most grossly unequal regimes possess far more than anybody has ever suspected. The value of their savings is immense – many times all the foreign aid and investment received since 1945. In Egypt alone the assets of the poor are 55 times greater than all foreign investment ever recorded, including the funding of the Suez Canal and the Aswan Dam. But the poor and lower middle classes hold their resources in defective forms: they have houses but not titles, crops but not deeds, businesses

but not statutes of incorporation. They have no alternative but to live outside the law.

Five years ago, my research organisation – the Institute of Liberty and Democracy – and hundreds of professionals from various countries went into the streets of developing and former Communist nations to learn what real people are achieving inside and outside the underground economy. We closed our books and opened our eyes, and the results of our findings have been dramatic.<sup>3</sup> The data we have collected – block by block, farm by farm in Asia, Africa, the Middle East and Latin America – show that the world's poor and lower middle classes have accumulated all the assets needed for successful capital.

Why then are these people so underdeveloped? Why can't they turn their assets into liquid capital, the kind that generates new wealth by increasing production and productivity?

## Unravelling the mystery of capital

The answer is simple: to be useful in an expanded market, capital must first be represented in a property document where it can then be assigned a status that allows it to produce additional value. What most people possess outside the West is not 'paperised' in

Hernando de Soto spoke about his most recent book, *The mystery of capital: Why capitalism triumphs in the West and fails everywhere else*, and the work of the Institute of Liberty and Democracy (ILD) at a seminar hosted by the Centre for Development and Enterprise in Johannesburg.

After his presentation, Hernando de Soto took questions from the audience. His responses to a selection of them are reflected below. Participants in the seminar are listed at the end of this document.

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### About Hernando de Soto

Hernando de Soto is the founder and president of the Institute of Liberty and Democracy (Lima) and a former economic and political advisor to the president of Peru. As President Alberto Fujimori's Principal Advisor, de Soto initiated Peru's economic reforms and played

a leading role in modernising its economic and political system. He and the ILD are currently working in Asia, the Middle East and Latin America on the practical implementation of measures for bringing the poor into the economic mainstream.

*This is an executive summary of a the seminar. The views expressed are not necessarily those of CDE.*

such a way as to produce capital.<sup>4</sup> Because the rights to their possessions are not adequately documented, these assets cannot readily be turned into capital, traded outside of narrow local circles where people know and trust each other, used as collateral for a loan, and used as a share against an investment.

In the West every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead an invisible, parallel life alongside their material existence. Third world and former communist nations have been unable to give the overwhelming majority of their citizens access to this representational process.

The process within the formal property system that breaks down assets into capital is extremely difficult to visualise. It is hidden in thousands of pieces of legislation, statutes, regulations and institutions that govern the system. The genius of the West was to have created a system that allowed people to grasp with the mind values that human eyes could never see and to manipulate things that hands could never touch. It devised new ways to represent the invisible potential locked up in the assets we accumulate. The absence of this process in poorer regions of the world is not the consequence of some Western monopolistic conspiracy. It is rather that Westerners take this mechanism so completely for granted that they have lost all awareness of its existence.

### Money presupposes property

Capital is now confused with money, which is only one of the many forms in which it travels. The mind wraps itself around 'money' more easily than 'capital'. But it is a mistake to equate capital with money. Money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production. You need a property right before you can make money. Even if you loan money, the only way you can earn it is by loaning or investing it against some kind of property document that establishes your rights to principal and interests. To repeat: money presupposes property.

It is the unavailability of the essential representations of property that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.

This is the mystery of capital. Solving it requires an understanding of why Westerners, by represent-

ing assets with titles are able to see and draw out capital from these.

### Getting perspective from the outside

Anyone trapped inside such a legal morass would be hard-pressed to figure out how the system actually works. The only way to see it and understand how it functions and what effects it produces is from outside – from the informal 'extralegal' sector – which is where my colleagues and I do most of our research.<sup>5</sup>

Massive extralegality is not a new phenomenon; it is what always happens when governments fail to make the law coincide with the way people live and work. The ILD has been looking at the relationship between law and marginality for many years. My previous book *The Other Path: The invisible revolution in the third world* captured some of what we learnt. For example, a large informal economy covering 70-80% of the population does not mean that people are not entrepreneurial but rather that they do not – or cannot – operate within the legal system. We found daunting obstacles:

- in Peru, for a business to become legal took more than three hundred days, working six hours a day. The cost: thirty-two times the monthly minimum;
- in Haiti, obtaining a lease on government land – a preliminary requirement to buying – takes 65 steps;
- in Egypt, the person who wants to acquire and legally register a lot on a state-owned desert land must wend his way through at least 77 bureaucratic procedures at 31 public and private agencies. The process could take anything from 5 to 14 years. This perhaps explains why 4.7 million Egyptians have chosen to build their dwellings illegally.

Faced with obsolete requirements and legal obstacles, the poor develop an alternative extralegal economy using informal arrangements to protect their assets.

From my viewpoint in the extralegal sector, I have seen that the formal property systems of the West produce six effects that allow their citizens to generate capital. The incapacity elsewhere in the world to deploy capital stems from the fact that most of the people in the Third World and in former communist countries are cut off from these essential effects. The challenge these countries face is not whether they should produce or receive more money but whether they can understand the legal institutions and summon the political will necessary to build a property system that is accessible to the poor.

**It is a mistake to equate capital with money ... you need a property right before you can make money**

## The six effects of legal property rights

### 1. Fixing the economic potential of assets

Capitalism travels on paper, on plastic, it travels by representation. It travels not in real things but through an apparatus of laws that sets the rules of the game. Legal property gave the West the tools to produce surplus value over and above its physical assets. What creates capital in the West is an implicit process buried in the intricacies of its formal property systems that provides the process, the forms, and the rules that fix assets in a condition that allows us to realise them as active capital. Formal property records and titles thus represent our shared concept of what is economically meaningful about any asset. They capture and organise all the relevant information required to conceptualise the potential value of an asset and so allow us to control it. Any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market.

The crucial point to understand is that property is not a physical thing that can be photographed or mapped. It is not a primary quality of assets but the legal expression of an economically meaningful consensus about assets and how they should be held, used and exchanged. Many of the things we do with our assets are not concerned with the physical objects, but through their representation in the form of property titles or shares that allow one to manage the values related to those assets, leverage it and multiply it many times over. Property is the realm where we identify and explore assets, combine them, and link them to other assets. Law is the instrument that fixes and realises capital. In the West, the law is less concerned with representing the physical reality of buildings or real estate than with providing a process or rules that will allow society to extract surplus value from these assets.

Walk down the streets in Lima and in New York: in both cases you see buildings, factories, people working – on different scales maybe. If you look closely at what is happening, American buildings seem to have a parallel invisible life which buildings in Lima do not have.

Assets in developing and former communist countries primarily serve immediate physical purposes: houses are used for shelter; parcels of land are tilled, sowed and harvested; merchandise is bought and sold. But in the United States and Europe, the same assets lead a parallel life as capital outside the physical world. For example, they're acting as collateral, as equity that is the basis for issuing shares against investment, as guarantees for credit, as addresses that are very precise and make

people accountable so you can supply them with electricity and water, for which they receive bills that they pay.

Why can't buildings and land elsewhere in the world also lead this parallel life? What detaches value from a simple house and fixes it in a way that allows us to realise it as capital? What is it that fixes the potential of an asset so that it can put additional production into motion?

We made a list of a hundred things that a building does in the US that it does not do in Latin America. We came to define that as capital. Like energy, capital is a dormant value. Bringing it to life requires us to go beyond looking at our assets as they are to actively thinking about them as they could be. The term 'capital' must do two jobs simultaneously, capturing not only the physical dimension of assets but also their potential to generate surplus value. When a building does not have that additional life, it is 'dead capital' – it's an asset but it does not have this parallel life. Poor people might own the asset but they cannot make its value work for them. If you do not have this parallel life to the physical life of the assets you do not have a capitalist world. Without formal property to extract their economic potential and convert it into a form that can be easily transported and controlled, the assets of developing and former communist countries are like water in a lake high in the Andes – an untapped stock of potential energy.

In the case of Latin America we privatised state corporations as part of the 'Washington consensus' of the 1990s. When trying to privatise the Peruvian telephone company, worth \$53million dollars on the Lima stock exchange, we found that nobody wanted to buy it. People do not buy companies, telephones, buildings, what they want to buy are the shares or property title of the company. We had to hire British merchant bankers, talk to people who buy telephone companies and learn about what makes a good title. In the end we retitled all our state companies according to standards, customs and procedures that purchasers would understand. We ended up privatising the Peruvian Telephone Company and selling it three years later (after spending \$20million) for \$2billion dollars, 37 times its original value. That's capital. Capital is all those hidden values and assets that come through understanding that the telephone company is more than just wires and bricks.

### 2. Integrating dispersed information into one system

The reason capitalism has triumphed in the West while sputtering in the rest of the world, is because

**Even those who live under the most grossly unequal regimes possess far more than anybody has ever suspected**

most of the assets in Western nations have been integrated into a formal representational system. For Westerners today, there is only one law – the official one. Yet the West’s reliance on an integrated property system is a phenomenon of at most the last two hundred years. Integrated property systems appeared only about a hundred years ago; Japan’s integration happened little more than fifty years ago. Diverse informal property arrangements were once the norm in every nation. The reason it is hard to follow the history of the integration of widespread property systems is that the process took place over a very long time.

This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators and judges pulled together the scattered facts and rules that had governed property throughout cities, villages, buildings and farms and integrated them into one system. This ‘pulling together’ of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols, or oral testimony. But the information was atomised, dispersed and not available to any one agent at any given moment. For knowledge to be functional, advanced nations had to integrate into one comprehensive system all their loose and isolated data about property.

Western law was built by discarding what was not useful and enforceable, and absorbing what worked. Standardised and universally available property information means that what owners can do with their assets benefits from the collective imagination of a larger network of people. As a result of integration, citizens in advanced nations can obtain descriptions of the economic and social qualities of any available assets without having to see the asset itself. They no longer need to travel around the country to visit each and every owner and their neighbours; the formal property system lets them know what assets are available and what opportunities exist to create surplus value. Consequently, an asset’s potential has become easier to evaluate and exchange, enhancing the production of capital.

Developing and former communist nations have not done this. In all the countries I have studied, I have never found just one legal system but dozens or even hundreds, managed by all sorts of organisations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organisa-

tions. All the separate, loose extralegal property arrangements characteristic of most Third World and former communist nations must be woven into a single system from which general principles of law can be drawn. In short, many social contracts ‘out there’ must be integrated into one, all-encompassing social contract.

### *3. Making people accountable: The mixed blessing of formal property systems*

Western nations’ respect for property and related transactions is hardly encoded in their citizens’ DNA. It is rather the result of having enforceable formal property systems. The integration of all property systems under one formal property law shifted the legitimacy of the rights of owners from the politicised context of local communities to the impersonal context of law. By transforming people with property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighbourhood relationships or make local arrangements to protect their rights to assets.

Once inside a formal property system, however, owners lose their anonymity. By becoming inextricably linked to real estate and businesses that could be easily identified and located, people forfeited the ability to lose themselves in the masses. This anonymity has practically disappeared in the West. People who are part of a formal property system have addresses, credit records and identifiable assets. A westerner who does not honour his debts can be identified and blacklisted; the bailiffs know where to find him, and what to seize. So, there are powerful incentives to play by the rules.

Essentially, the formal property systems of the West have bestowed mixed blessings. Although they provided hundreds of millions of citizens with a stake in the capitalist game, what made this stake meaningful was that it could be lost. A great deal of the power of legal property comes from the accountability it creates, from the constraints it imposes, the rules it spawns, and the sanctions it can apply.

The lack of legal property explains why citizens in developing and former communist nations cannot make profitable contracts with strangers, cannot get credit, insurance, or utilities services: they have no property to lose. Because they have no legal property to lose, they are taken seriously as contracting parties only by their immediate family and neighbours. People with nothing to lose are trapped in the grubby basement of the precapitalist world.

**Legal property gave the West the tools to produce surplus value over and above its physical assets**

#### 4. Making assets fungible

One of the most important things a formal property system does is transform assets from a less accessible condition to a more accessible condition, so that they can do additional work. By uncoupling the economic features of an asset from its rigid, physical state, representation makes the asset 'fungible' – able to be fashioned to suit various transactions.

Representation enables one to divide assets without touching them. A factory or telephone company may be an indivisible unit in the real world, but in the conceptual universe of formal property representation it can be subdivided into any number of portions. My credit card is uncoupled from the savings that I have in Peru, now it travels in plastic. Citizens of advanced nations are able to split most of their assets into shares, each of which can be owned by different people, with different rights, to carry out different functions. Thanks to formal property, a single factor can be held by countless investors, who can divest themselves of their property without affecting the integrity of the physical asset. Westerners can adapt their assets to any economic circumstance to produce continually higher valued mixtures, whereas their Third World counterparts remain trapped in the physical world of rigid, non-fungible forms.

#### 5. Networking people

Formal property law enables people to do business with strangers. By making assets fungible, by attaching owners to assets, assets to addresses, and ownership to enforcement, and by making information on the history of assets and owners easily accessible, formal property systems converted the citizens of the West into a network of individually identifiable and accountable business agents.

Extralegal property arrangements characteristic of many developing and former communist countries are often dispersed among dozens, sometimes hundreds of communities; who owns what, for example, is known only to insiders or neighbours. Consequently, what people in those countries can do with their property is limited to the imaginations of the owners and their acquaintances. By contrast, integrated legal property systems destroyed most closed groups while inviting the creation of a larger network where the potential to co-operate and create capital increased substantially. Properly understood and designed, a property system creates a network through which people can assemble their assets into more valuable contributions.

#### 6. Protecting transactions

One important reason why the western formal property system works like a network is that all the property records (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected. Public record keepers administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattels, ships, industries, mines, or airplanes. These files will alert anyone eager to use an asset about things that may restrict or enhance its realisation, such as encumbrances, easements, leases, arrears, bankruptcies and mortgages.

In addition to public record-keeping systems, many other private services have evolved to assist parties in fixing, moving, and tracking representations so that they can easily and securely produce surplus value. These include private entities that record transactions, escrow and closing organisations, abstractors, appraisers, title and fidelity insurance firms, mortgage brokers, trust services and private custodians of documents. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital.

The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. How else can we explain that in developing and former communist nations people are still taking their pigs to market and trading them one at a time, as they have done for thousands of years, whereas in the West, traders take representations of their rights over pigs to market? Traders at the Chicago commodities exchange, for example, deal through representations, which give them more information about the pigs they are trading than if they could physically examine each pig. They are able to make deals for huge quantities of pigs with little concern about the security of transactions.

Formal property's contribution to mankind is not the protection of ownership; squatters, housing organisations, mafias, and even primitive tribes manage to protect their assets quite efficiently. Property's real breakthrough is that it radically improved the flow of communication about assets and their potential. It also enhanced the status of their owners, who became economic agents able to transform assets within a broader network, significantly reducing transaction costs of mobilising and using assets.

Many title systems in developing nations fail to produce capital because they do not acknowledge

**In developing and former communist nations people are still taking their pigs to market and trading them one at a time. In the West, traders take representations of their rights over pigs to market**

that property can go way beyond ownership. These systems function purely as an ownership inventory of deeds and maps standing in for assets, without allowing for the additional mechanisms required to create a network where assets can lead a parallel life as capital. In these countries, the law and official agencies are trapped by early colonial and Roman law, which tilt toward protecting ownership. In effect, they have become custodians of the wishes of the dead. This may explain why most of the assets in developing and former communist countries have slipped out of the formal legal system in search of mobility; while the creation of capital in western property happens so easily.

Cut off from these essential six effects of property, most people in developing and former communist nations cannot insert their assets into the legal property system, no matter how hard they try, and end up holding their assets extralegally. Those who can afford expert lawyers, insider connections and the patience required to navigate the red tape of their property system are only a tiny minority. The great majority cannot get the fruits of their labour represented by the formal property system. So, in developing countries capitalism becomes like a private club open only to a privileged few, which enrages the billions standing outside looking in. In such cases the law is not on the side of people, it's a law that helps the established capitalism of the few, an elite and not the majority. This capitalist apartheid will inevitably continue until we all come to terms with the critical flaw in many countries' legal and political systems that prevents the majority from entering the formal property system. This leads me to talk about the process of 'discovering the law'.

### Discovering the law: Listening to the 'barking dogs'

For property law to be respected, it has to reflect what is happening on the ground and include as many people as possible. Governments must uncover the existing social contracts on property established by the poor and integrate them into the official law. Once governments have uncovered information on existing social contracts, they can begin the work of organising the contracts into formal statutes, comparing informal arrangements with existing formal law, and deciding how each has to be adjusted to build a common regulatory framework for all citizens. How can this be accomplished? How can governments find out what the extralegal property arrangements are?

That was precisely the question that was put to me by five members of the Indonesian cabinet. Fearing that I would lose my audience if I went into a drawn-out technical explanation on how to structure a bridge between the extralegal and legal sectors, I came up with another way, an Indonesian way, to answer their question. I told them about my experience of strolling through the rice fields in Bali. I had no idea where the property boundaries were. But the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs may have been ignorant of formal law, but they were positive about which assets their masters controlled.

I told the ministers the Indonesian dogs had the basic information they needed to set up a formal property system. By travelling their city streets and countryside and listening to the barking dogs, they could gradually work upward, through the vine of extralegal representations dispersed throughout their country, until they made contact with the ruling social contract. 'Ah' responded one of the Ministers, '*jukum adat!*' (the people's law)

Discovering 'people's law' is how western nations have built their formal property systems. The law that prevails today in the West did not come from dusty tomes or official government statute books. It is a living entity, born in the real world and bred by ordinary people long before it got into the hands of professional lawyers. The law had to be discovered before it could be systematised.

Any government that is serious about reengineering the ruling informal agreements into one national formal property social contract needs to listen to its 'barking dogs'. To integrate all forms of property into a unified system, governments must find out how and why the local conventions work and how strong they actually are. It is up to government to find out what these extralegal arrangements are and then to find ways to integrate them into the formal property system. They will not be able to do that by hiring lawyers in high-rise offices in Delhi, Jakarta or Moscow to draft new laws. They will have to go out into the streets and roads and listen to the 'barking dogs'. This involves carrying out original research: reformers have to put themselves in the shoes of the poor and walk their streets. Official statistics do not contain the information they need. The failure to do so explains why past attempts at legal change in developing and former communist countries have not worked.

My colleagues and I have found that the social contracts of the extralegal sector are not merely implied social obligations that can be inferred from societal behaviour; they are also arrangements that are explicitly documented by real people. As a

**People with nothing to lose are trapped in the grubby basement of the precapitalist world**

result, these extralegal social contracts can actually be touched, and they can also be assembled to build a property and capital formation system that will be recognised and enforced by society itself. People have created their own law, way before we get there. You need to find out what are the deals being made in the black market by common people. The fact that they are not structured formally does not mean that they do not exist. The role of the reformer is to find the common denominators and restructure the system to deal with the sources of law that come up from the bottom. That's how you can create a capitalist system.

### The politics of reform

Emancipating people from bad law is a political job and implementing major legal change carries a political responsibility:

- Small but powerful vested interests – mostly represented by the countries' best commercial lawyers – are likely to oppose change unless they are convinced otherwise. Bringing well-connected and moneyed people onto the bandwagon requires not consultants committed to serving their clients but talented politicians committed to serving their people;
- Creating an integrated system is not about drafting laws and regulations that look good on paper but rather about designing norms that are rooted in people's beliefs and are thus more likely to be obeyed. Being in touch with real people is a politician's task;
- Prodding underground economies to become legal is a major political sales job. Governments must convince poorer citizens – who mistrust government and survive on tight parochial arrangements – and some of the mafias who protect them to buy an entry ticket into a much bigger and looser game. Governments must also convince influential leftists, who in many coun-

tries are close to the grassroots, that enabling their constituencies to produce capital is the best way to help them. Governments need to make a strong case that a redesigned, integrated property system is less costly, more efficient and better for the nation than the existing anarchical arrangements.

Without succeeding on the legal and political fronts, no nation can overcome the legal apartheid between those who can create capital and those who cannot. The promoters of capitalism, still arrogant in their victory over communism, have yet to understand that their macro-economic reforms are not enough. Globalization is occurring because developing and former communist nations are opening up their once protected economies, stabilizing their currencies, and drafting regulatory frameworks to enhance international trade and private investment. All of this is good. What is not so good is that these reforms assume that these countries' populations are already integrated into the legal system and have the same ability to use their resources in the open market. They do not.<sup>6</sup> Imitating capitalism by importing McDonald's and Blockbuster franchises, is not enough to create wealth. What is needed is capital, and this requires a complex and mighty system of legal property that we have all taken for granted. Without formal property, no matter how many assets they accumulate or how hard they work, most people will not be able to prosper in a capitalist society. They will continue to remain beyond the radar of policymakers, out of the reach of official records, and thus economically invisible.

The former communist nations and the Third World are exactly where Europe, Japan and the United States were a couple of hundred years ago. Like the West, they must identify and gather up the existing property representations scattered throughout their nations and bring them into one integrated system to give the assets of all their citizens the fungibility, bureaucratic machinery, and networks required to produce capital.

**People have created their own law. You need to find out what are the deals being made ... by common people**

### Macroeconomic stabilisation programmes must not forget the poor

Hernando de Soto argues that 'The challenge to leaders in developing and former Communist nations, from Russia's President Vladimir Putin to South Africa's President Thabo Mbeki, is to address the fact that most of the citizens they govern do not have property rights. They have to face the fact that macroeconomic stabilisation programmes that their governments have carried out have performed only a fraction of the work required to create a democratic market economy. The fundamental shortcoming of

these macro economic programmes is that they forgot to focus on the poor. The time has come to take the issue of the poor away from the charitable agendas of the first ladies and insert it into the working agendas of the heads of states. As capitalism falters in five sixths of the world, the time is ripe to take the subject of property away from conservative legal establishments and put it in the hands of politicians committed to progress'.<sup>7</sup>

**Questions from the audience:****Is market-orientation a pre-requisite on the part of politicians to recognise and take forward the kind of programme you're suggesting?**

In my own country our most important enemies have always been on the right. My first book was dedicated to the left. I agreed with their objectives because their hearts are in the right places, they want to help the poor – but I did not agree on the means. I believed they underestimated the power of markets and libertarian thinking. The first people to pick up our programmes in Peru were on the left, Allan Garcia in the late 1980s and Fujimori who beat the right wing candidate, Vargas Llosa.

**After putting in place a parallel system in relation to physical and other assets that work and are recognised by people, is there a spontaneous development of capitalism? Do people become more productive because they realise they can retain ownership of what they're producing?**

By 1993 we had implemented reforms in Peru that lowered the time taken to record a company from on average 300 days to just one day. Some 276 000 of those entrepreneurs recorded their businesses voluntarily in new registry offices we set up to accommodate them – with no promise of tax reductions. Their underground businesses had paid no taxes at all. Four years later, tax revenues from formerly extralegal businesses totalled US\$1.2 billion. We

were successful because we modified company and property law to adapt to the needs of entrepreneurs accustomed to extralegal rules. We also cut dramatically the costs of the red tape to enroll businesses. By 1994 Peru had the world's highest growth rate of about 13% per annum. It was a huge shock. The fact is that people do come in.

This is not to say that people do not care about their tax bill. But anybody who is on the streets who lives by borrowing \$10 in the morning and has to pay back \$11 at the end of the day knows how to sliver thin profit margins. The moment you explain to him in simple terms how lowering of the cost of the law to him is going to make it easy for him to come in and allow him to leverage, he can understand this. People at the poorest levels are conscious of these aspects. All we had to do was make sure the costs of operating legally were below those of surviving in the extralegal sector, facilitate the paperwork for legalisation, make a strong effort to communicate the advantages of the program, and then watch hundreds of thousands of entrepreneurs happily quit the underground. Wealth does ensue almost immediately if you get the programme going and it is well structured. Extralegal manufacturers and shopkeepers know basic arithmetic.

Contrary to popular wisdom, operating in the underground is hardly cost-free. Extralegal businesses are taxed, for example, by the lack of good property law and continually having to hide their operations from the authorities. Our research in the

**In developing countries capitalism becomes like a private club open only to a privileged few**

**The risk of legalising**

Writing for the *New York Review of Books* Jeff Madrick raises a series of challenging practical questions<sup>8</sup>:

- *'The mystery of capital* is a theoretical tract. De Soto wants us to believe that property rights are the principal source of economic growth, and that they always have been; but he has written an abstract book about a problem that is decidedly down to earth: "It is the unavailability of these essential [property rights] that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capital work... This is the mystery of capital. This is a bolder contention than de Soto may realise. To support it he offers a few examples of how expensive achieving legality can be in the developing world, and he gives a relevant

but oversimplified history of the legal development of land policies in the United States. But in light of the many questions his proposals raise, such arguments are simply inadequate. Can underground business people risk coming out into the open? Is there sufficient market for their goods or services? What is the quality of schools their children will attend? De Soto does not address these issues because he has loftier aims.'

- 'Eliminating regulations would surely energise commerce, but we are eager to know which of these regulations actually have some value and which do not. De Soto assumes that almost all the obstacles in the way of legalising business are the unnecessary handiwork of entrenched, usually corrupt, and elitist bureaucracies, whether they are administered by right-wing dictatorships or well-meaning

democracies. Such reforms would matter but we need some demonstration of just how much.'

- 'One of de Soto's central claims is particularly difficult to accept. Are most of the informal businesses he writes about now willing, as he suggests, to pay taxes in order to enjoy the potential benefits of expansion that legality may, or may not bring? It seems likely that many people will prefer to take a dollar of tax savings today, and remain underground, rather than wait for two dollars of possible but uncertain gains in the future. The basic issue here is not whether legality makes sense or whether everyone would be better off at some future date by legalising the informal economy, but how people can be persuaded to bring about the changes that de Soto recommends.'



countries we have worked with has confirmed that being free from the costs and nuisance of the extralegal sector generally compensates for paying taxes. What determines whether you remain outside is the relative cost of being legal.

**The issue of race and capital is key in South Africa. It's an issue of accessing capital and making capital productive. There's friction between law and the regulations of private institutions. The law does not reach far enough into private corporations to allow us to change that. What is your comment?**

I do not know enough about SA, I'm interested in learning more. But I do know that if you tell a politician, not a technocrat, that a large number of people are out of the legal system, he should listen.

In Egypt and Peru the majority of the people, the poor, already have assets. You give them an enormous leg-up just by formalising their existing assets. In South Africa a minority has the majority of real estate assets. You need to do something else.

My impression from a previous visit about five years ago is that South Africa is at the beginning of a process that we are at the end of in Latin America. There, poor people have come into town over the last 50 years and taken what was not theirs, according to the law. So redistribution has taken place – spontaneously through people squatting, through agrarian reform programmes, through guerrillas. What we're faced with now is a *fait accompli* and we had better restructure on that basis.

In your case, instead of being the victims of a process of violent redistribution, you can actually do something planned.

**One of the greatest problems we encounter is that the market is inaccessible in SA. Whatever efforts are made to get excluded people into the mainstream of the economy, the fact of the matter is that this is a very difficult task and they never get to the centre. What is your view of this?** You must identify the reasons why they are not accessing the market. In every case, you have to identify the obstacles first, which is complex because many of them are hidden. You identify the obstacles through a consultative process that is parallel to the democratic one. Then you engage in a diagnostic process to help you find out why peasants are not getting their tomatoes to the market and so on.

In Peru, we undertook a cost-benefit analysis of the law and put in systems incentivising the public and public administration to inform us once a procedure had begun so that we could calculate the transaction costs of doing business. That is the only

way you can find out, by measuring things. It really has to do with democracy and getting inside information otherwise it's difficult to understand why people remain on the outside.

**How do you change a system where existing property rights are held by a few? How do you do this without damaging the creation of wealth?**

You have to come to a stage where everyone is willing to respect the law because it's got something to offer everyone. What would be important is not just to study the law on how people today – even street vendors who've only been on the street for two months – are coming to arrangements among themselves to understand where the kernel of the law is, you also need to find out if the amount of assets they have in their hands is going to be satisfactory.

Obviously you have to do some kind of re-engineering but that means getting the figures into place before developing a strategy to make the necessary transition.

It might be useful to find out from other countries what redistributive and compensatory measures were taken. Each country has specific characteristics, if the poor are 90% and their assets available to them are only 2%, something else needs to be done than what we're doing in Latin America.

**What do you do in a situation where there is no shared understanding that capitalism is the way? Do you start on this path or do you try to get some shared understanding about what path you want to go on is?**

All books have a strategy and I followed my agent's advice to get the kind of title that would be a success in the US. But, if I had to start a promotion programme to get in touch with the poor, the last word I'd use is capital or capitalism. These are terrible words. They are associated with a series of bad things. When you're working in the field with people who are not going to read the book, what words do you use? You need to arrive at a shared understanding with them, and at least 30% of our budget will be for communications, about talking to people with as little misunderstanding as possible. We hold all our public hearings in the streets or open forums, talking to people from different social strata.

'Property creation is not at all like a privatisation program, which involves selling only a dozen or so bundles of assets a year. The goal of property reform is to award property rights for millions of assets to millions of people in a short time. This means that at least half the job is about communications. The leaders of property reform need to describe how popular capitalism will affect many different interest groups, show them the benefits

**The goal of property reform is to award property rights for millions of assets to millions of people in a short time**

they will derive from it, and persuade them that it is a win-win exercise for all segments of society. For the extralegal sector, these leaders must address their pent-up entrepreneurial energy and demonstrate the advantages of integrating a new formal law. For the legal sector, they must explain that the proposed reforms will not hurt legitimate and enforceable rights and that there will be aggregate gains for all interest groups. Creating a property system that is accessible to all is primarily a political job because it has to be kept on track by people who understand that the final goal of a property system is not drafting elegant statutes, connecting shiny computers, or printing multicoloured maps. The goal of formal property is to put capital in the hands of the whole nation.”

### **What do you do about the ‘barking of competing dogs’?**

When you get close to the grassroots you’re able to solve most disputes. Much of the competition you see is about different pieces of paper. If there were not, we could be effectively like the West where they can settle property claims on paper. What happened in our country is that we were not able to do so anymore because the paper has ceased to reflect competing claims in any useful manner.

### **Have you learnt anything unexpected in your country studies?**

The more interesting aspect is really how similar all the countries we’ve touched on have been rather than how different. What you have to do is learn to express the issue in the local cultural terms that people will understand.

### **How do you respond to those critics who say that you have a ‘single bullet’ theory of development?**

This is a book about property, about capital. I’m not saying that education is not important, or health care is not important, nobody is saying that race is not important, all of these things are and they have to be discussed. But I write one book at a time.

What I’m saying is that there seems to be a very important instrument for creating a market economy that works, that is not in place today and this is a major sticking point.

### **Do you need one or two specific conditions that need to be in place for your exercise to be successful and enable people to accumulate wealth through the creation of titles? What are these?**

Democracy, understood as an information system, is important. Western countries were able to develop successful market economies because they have listening devices and devices that allow them to cor-

rect things that go wrong.

Essentially the market revolution is a revolution of ordinary people. It works in different ways in different places but the important thing is that in all of them the ‘dogs are barking’. Democracy assumes different forms in different countries. A key difference is where decision-making happens. But governments which have created laws that have enabled the structuring of an efficient market economy that is generally accessible and helps citizens to prosper in equitable conditions, are very tied into the democratic process, understood as a system that is in touch with the ‘barking dogs’. There are obviously many formulae for this, a lot of them depend on culture, on talking to your own people in ways they understand. It is a process that is never ending and nobody is ever really totally satisfied.

### **There have been some problems with land reform in Latin America where many peasants received land but did not have the skills, knowledge or resources to work that land and some ended up selling land back to the rich people who owned the land before them. Can you reflect on these issues?**

The first thing that became clear when we studied history is that this is a political exercise. You’re going to change society and in each case you have to decide what you’re going to do. Those countries that have embarked on reform as a technological exercise have not been very successful. Giving people access for their assets to enter the market is emancipation, a tremendously political exercise. It requires communication at the political level. In the case of Peru, once we convinced government to address the 90% that was this constituency we structured a plan so that it could proceed. The question is: is the message the same for each group? It’s not. So, your overall strategy has to take into consideration that different groups are going to require different messages.

We did not touch those that already had private property secured by the old establishment system. They were in parts of town that were easy to isolate and put boundaries around. We said, ‘you keep the old Spanish registry system. We’re going to touch those who cannot get inside the registry’. So, immediately we covered ourselves on the flank. What happened of course, is that the new system we brought in with all its information technology was much more effective and secure than the old one. The people in the old system started complaining. That’s the way it should be, it’s like pulling on a string, you can’t push a string but you can pull it.

A different strategy is needed for the agricultural sector. There are at least 400 sociologists to tell

**Prodding underground economies to become legal is a major political sales job**

you that Peruvians are built to work in communities of the Andean Indian sort and they spend a lot of time funded by Wisconsin university to affirm that. You do not walk into that battle and face a Waterloo, you start in the urban sector to which the same indigenous people have migrated and broken up their land into different plots. Some of them are organised collectively but in response to practical considerations. They are operating in terms of a local social contract. You do your work in the urban areas then after a while peasants start wandering down to Lima to demand that you do this with them back home and then you pull the string. It's a strategy.

In our part of the world we have had to deal with squatters controlling 5-10% of Peru's territory. They're big entrepreneurs and make a lot of money. You have to create a space in the law for them to become formal real estate dealers. It depends what kind of political action you're ready for. In Peru we were tired of violence so we absorbed them.

We have at least fifteen sectoral messages. If the head of state does not understand the need for a political message or is unwilling to adopt it, it is not going to happen. You need engaged leaders who can communicate, you've got to give them the instruments and work everybody's interest into this. You have to popularise the message. That must be built into the strategic plan.

**Even in countries where there are supposedly adequate legal frameworks and property rights one finds that the rich are getting richer and the poor are getting poorer. Are property rights the main issue?**

I'm not a defender of the status quo on property rights. What I'm saying is that a property rights system brings with it many more answers than just certification of ownership. It allows credit and investment to work, it allows the Peruvian or Brazil-

ian telephone company to capture the value of a series of things that are close to or about the assets, but are not the assets themselves.

There's a continual debate back and forth about property rights. The creation of information technology is an interesting example. Originally the idea of linking cheap computers together was started for defence purposes, but the professors and students working on this saw the commercial possibilities of using this as the internet. Bankers were at a loss. There was no way of creating a property right over blueprints or ideas on how to interconnect software. New conceptions had to be developed. Law firms in northern California started creating what they called consignee papers that venture capital could use in standard ways to finance crazy ideas. On the east coast, on Wall Street, people started creating bonds that they could launch on the market since the banks were not willing to act. Banks did not like this at all and called them junk bonds. In the US, bankers were responsible for 80% of all financial intermediation in that country in the 1960s. Today, they are only responsible for 30%. The revolution behind banking has been a revolution in property rights – that is, about how you can claim a right to one thing or another.

If there is a concern today that the existing property rights system benefits too many multinationals rather than other companies, there will be a dialogue and a debate and the system will be adjusted. The important thing is that it is adjusted through law. For that you need a property rights framework. The moment you have this debate outside property law, which is what happens in a developing country like mine, it becomes unmanageable.

It is so important to bring everyone within a framework of rules because then you'll be able to identify the surplus value that is hidden in assets and in social contracts. But it is also within the con-

**You have to popularise the message. That must be built into the strategic plan**

## Bad culture or bad laws: Which keeps countries poor?

Michael Novak contrasts de Soto's rejection of culture as an explanation for economic backwardness with the views of twenty-two authors that Lawrence E Harrison and Samuel P Huntington have assembled in *Culture Matters*.

The latter argue, 'After a half-century of development assistance, half of the adult population in twenty-three countries (mostly in Africa) are illiterate; life expectancy is below sixty years in forty-five countries; children under five die at

rates in excess of 10% in thirty-five countries; and democracy remains non-existent or weak in most of Africa and Asia and parts of Latin America. The three prominent theories of the twentieth century – that these failures are explained by colonialism, dependency and racism – have lost their power to persuade. Thus the cultural theories of Alexis de Tocqueville, Max Weber and Edward Banfield seem to offer better models.'<sup>10</sup>

So which is it? asks Novak. 'Is de

Soto correct that institutions unlock the gate into development? Or is it culture? De Soto is surely right that simple changes in law have had a dramatic effect on economic behaviour. On the other hand, at least some changes in culture are needed to propel political support for the institutional reforms de Soto calls for. Culture, not institutions, determines the success of a society. But new institutions can change a culture for the better. These two truths...complement each other.'<sup>11</sup>

text of rules that you can have a more productive debate on how to arrange rights in such a way that most people are satisfied and more wealth is produced.

**The ‘culture’ theorists have gone for you. Can you talk about the role of culture and the criticisms that have been made of your book?**

Obviously cultural differences are real but what do you do with a bland statement from somebody in an Ivory Tower at a US university saying ‘It’s cultural. You Latin Americans are just culturally different’? What do you do with the argument that if Third World people failed to prosper, it is because they ‘missed the Protestant Reformation, or they are crippled by the disabling legacy of colonial Europe, or their IQs are too low’? <sup>12</sup> The suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland and California and culture again that explains the relative poverty of such equally diverse places as China, Estonia and Baja

California, is worse than inhumane; it is unconvincing. The disparity of wealth between the West and the rest of the world is far too great to be explained by culture alone. Most people want the fruits of capital – so much so that many, from the children of Sanchez to Kruschew’s son, are flocking to Western nations.<sup>13</sup>

Every time something does not work or you cannot explain it, it’s tossed into a big jar with a big label that says ‘it’s cultural’. Behind most of those arguments there is an ethnic or racist component. It is basically a way for Anglo-Saxons in North America to feel good about themselves.

What we try and do – as I’ve indicated with finding out where the ‘dogs bark’ – is to catch culture where it can be caught. I try to catch it by things that are significant and specific, I don’t go into broad generalisations. We’re dealing with an evolving culture all the time, but the way we deal with this is through political and legal instruments, not by just talking about it.

**The disparity of wealth between the West and the rest of the world is far too great to be explained by culture alone**

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## Participants in the seminar

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Firoza Adam	Economist, Chamber of Mines of SA
Ricardo Alen Sani	First secretary, Embassy of Chile
Dr Fitzroy Ambursley	Lecturer in economics, University of the Witwatersrand
Francis Antonie	Senior economist, Standard Bank
Roger Baxter	Chief economist, Chamber of Mines of SA
Ann Bernstein	Executive director, Centre for Development and Enterprise
Jack Bloom	MPL: Whip, Gauteng Provincial Legislature
Margali Bourdat	Research co-ordinator, Small Business Projects
Nigel Bruce	MP, Parliament of SA
Jim Buys	Chief economist, Anglo American Corporation of SA
Cas Coovadia	Transformation general manager, Banking Council of SA
Dr Simon Dagut	Senior research co-ordinator, CDE
Gabriel Davel	Chief executive officer, Micro Finance Regulatory Council
Dr Paul Davis	Chairman, Medical Rescue International
Anchen Dreyer	MPL: Whip, Gauteng Provincial Legislature
Dennis Dykes	Chief economist, Nedcor Investment Bank
Nick Erasmus	Researcher, Gauteng Provincial Legislature
Prof Johan Fedderke	Senior lecturer in economics, University of the Witwatersrand
Dr Gillian Godsell	Independent consultant
Judi Hudson	Senior research co-ordinator, CDE
Prof Douglas Irvine	Senior associate, CDE
Dr Azar Jammie	Chief economist, Econometrix
Jonathan Katzenellenbogen	Economics editor, Business Day
Gavin Keeton	Economist, Anglo American Corporation of SA
Derek Keys	Private
Prof Robin Lee	Consultant, Robin H Lee Associates
Peter Leon	Partner, Webber Wentzel Bowens
Prof John Luiz	Senior lecturer in economics, University of the Witwatersrand
Stephan Malherbe	Chief executive, Genesis Analytics (Pty) Ltd
Dawn Marole	Deputy chief executive officer, Fabcos
Irene Menell	Chairperson, Read Educational Trust
Thembekile Mlangeni	Economist, Department of Trade and Industry
Kurt Morais	Latin American researcher, SA Institute of International Affairs
Mpho Mosemane	Communications consultant, Johnnic Communications
Sello Mosieleng	Researcher, City of Johannesburg Metropolitan Municipality
Thabo Mosololi	Chief executive officer, Gobodo Incorporated
Mokela Mothabela	Executive director, National African Farmers Union
Zoyisile Mthobi	President, Soweto Junior Chamber of Commerce
Dr Nthato Motlana	Chairman, Kwacha
Sanusha Naidu	Senior Africa researcher, SA Institute of International Affairs
Enos Ngutshane	Executive manager, SA Rail Commuter Corporation Ltd
Brendan O'Connor	Chief executive officer, Rotek Industries (Pty) Ltd
Henderson Patrick	Programmes and project development director, USAID
Sue Ford Patrick	Consul-general, United States of America
Kevin Slaney	Strategic Projects, First National Bank
Michael Spicer	Executive vice-president, Anglo American Corporation of SA
Butch Steyn	MPL, Gauteng Provincial Legislature
Aleberto Valencia	Minister Counsellor, Peru
Yunaid Waja	Partner, Tax and Business Consultants
John Wilkinson	Managing director, Price Waterhouse Coopers
Dr Boris Yopo	His excellency, the Ambassador, Embassy of Chile
Theo van Wyk	Executive director, Remgro Limited
Paul Zille	Land Reform Credit Facility, Khula Enterprise Finance Ltd
Rev Keith Zondi	Deputy minister, Department of Public Works

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This report was edited by Judi Hudson, senior research co-ordinator, CDE



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#### **INTERNATIONAL ASSOCIATE**

Professor P Berger (Boston University)

Pilrig Place, 5 Eton Road, Parktown, Johannesburg 2193, South Africa  
PO Box 1936, Johannesburg 2000, South Africa  
Tel 27-11-4825140 Fax 27-11-4825089 e-mail: [info@cde.org.za](mailto:info@cde.org.za)

[www.cde.org.za](http://www.cde.org.za)